

Monetary Policy and the Economy in 1999

The U.S. economy posted another exceptional performance in 1999. Economic growth was robust, and, aside from the direct effects of higher crude oil prices, inflation remained subdued, in marked contrast to the rising inflation that eventually emerged in many previous economic expansions. The year brought additional evidence of substantial improvement in productivity growth since the mid-1990s, boosting living standards while helping to hold down increases in costs and prices despite very tight labor markets.

The Federal Open Market Committee's pursuit of financial conditions consistent with sustained expansion and low inflation required some adjustments to the settings of monetary policy instruments during the year. In the latter part of 1998, to cushion the U.S. economy from the effects of disruptions in world financial markets and to ameliorate some of the resulting strains, money market conditions had been eased. By the middle of 1999, however, with financial markets resuming normal functioning, foreign economies recovering, and domestic demand continuing to outpace increases in productive potential, the Committee began to reverse that easing.

As the year progressed, foreign economies, on the whole, recovered more quickly and displayed greater vigor than had seemed likely at the start of the year. Domestically, the rapid

productivity growth raised expectations of future incomes and profits and thereby helped keep spending moving up at a faster clip than current productive capacity. Meanwhile, the prices of most internationally traded materials rebounded from their earlier declines; this turnaround, together with a flattening of the exchange value of the dollar after its earlier appreciation, translated into an easing of downward pressure on the prices of imports in general. Core inflation measures generally remained low, but with the labor market at its tightest in three decades and becoming still tighter, the risk that pressures on costs and prices would eventually emerge mounted over the course of the year. To maintain the low-inflation environment that has been so important to the sustained health of the current expansion, the FOMC implemented three quarter-point increases in the intended federal funds rate over the year, ultimately reversing the easings undertaken during the autumn 1998 financial market turmoil.

The first quarter of 1999 saw a further unwinding of the heightened levels of perceived risk and risk aversion that had afflicted financial markets in the autumn of 1998; investors became much more willing to advance funds, securities issuance picked up, and risk spreads fell further—though not back to the unusually low levels of the first half of 1998. At the same time, domestic demand remained quite strong, and foreign economies showed some early signs of rebounding. The FOMC concluded at its February and March meetings that if these trends were to persist, the risks of the eventual emergence of

NOTE. The discussion here and in the next chapter is adapted from *Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978* (Board of Governors, February 2000). The data cited in the two chapters are those available as of mid-February 2000.

somewhat greater inflation pressures would increase, and it noted that a case could be made for unwinding part of the easing actions of the preceding fall. However, the Committee hesitated to adjust policy before having greater assurance that the recoveries in domestic financial markets and foreign economies were on firm footing.

By the May meeting, these recoveries were solidifying, and the pace of domestic spending appeared once again to be outstripping the growth of the economy's potential, even allowing for an appreciable acceleration in productivity. The Committee still expected some slowing in the expansion of aggregate demand, but the timing and extent of any moderation remained uncertain. Against this backdrop, the FOMC maintained an unchanged policy stance but announced immediately after the meeting that it had chosen a directive tilted toward the possibility of a firming of rates. This announcement implemented the disclosure policy adopted in December 1998, whereby major shifts in the Committee's views about the balance of risks or the likely direction of future policy would be made public immediately. Members expected that by making the FOMC's concerns public earlier, such announcements would encourage financial market reactions to subsequent information that would help stabilize the economy. In practice, however, those reactions seemed to be exaggerated and to focus even more than usual on possible near-term Committee action.

Over subsequent weeks, economic activity continued to expand vigorously, labor markets remained very tight, and oil and other commodity prices rose further. In this environment, the FOMC saw an updrift in inflation as a significant risk in the absence of some policy firming, and at the June meeting it raised the intended level of the federal funds

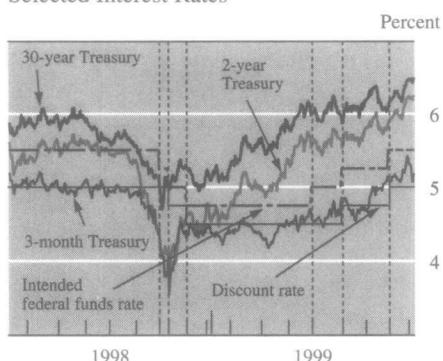
rate $\frac{1}{4}$ percentage point. The Committee also announced a symmetric directive, noting that the marked degree of uncertainty about the extent and timing of prospective inflationary pressures meant that further firming of policy might not be undertaken in the near term, but that the Committee would need to be especially alert to those pressures. Markets rallied on the symmetric-directive announcement, and the strength of this response, together with market commentary, suggested uncertainty about the interpretation of the language used to characterize possible future developments and about the time period to which the directive applied.

In the period between the June and August meetings, the ongoing strength of domestic demand and further expansion abroad suggested that at least part of the remaining easing put in place the previous fall to deal with financial market stresses was no longer needed. Consequently, at the August meeting the FOMC raised the intended level of the federal funds rate a further $\frac{1}{4}$ percentage point, to $5\frac{1}{4}$ percent. The Committee agreed that this action, along with that taken in June, would substantially reduce inflation risks and again announced a symmetric directive. In a related action, the Board of Governors approved an increase in the discount rate to $4\frac{3}{4}$ percent. At this meeting the Committee also established a working group to assess the FOMC's approach to disclosing its view about prospective developments and to propose procedural modifications.

At its August meeting, the FOMC took a number of actions that were aimed at enhancing the ability of the Manager of the System Open Market Account to counter potential liquidity strains in the period around the century date change and that would also help ensure the effective implementation of

the Committee's monetary policy objectives. Although members believed that efforts to prepare computer systems for the century date change had made the probability of significant disruptions quite small, some aversion to Y2K risk exposure was already evident in the markets, and the costs that might stem from a dysfunctional financing market at year-end were deemed to be unacceptably high. The FOMC agreed to authorize, temporarily, (1) a widening of the pool of collateral that could be accepted in System open market transactions, (2) the use of reverse repurchase agreement accounting in addition to the currently available matched sale-purchase transactions to absorb reserves temporarily, and (3) the auction of options on repurchase agreements, reverse repurchase agreements, and matched sale-purchase transactions that could be exercised in the period around year-end. The Committee also authorized a permanent extension of the maximum maturity on regular repurchase and matched sale-purchase transactions from sixty to ninety days.

Selected Interest Rates



NOTE. The data are daily. Short ticks indicate days on which the Federal Open Market Committee held a scheduled meeting or a policy action was announced. Vertical lines mark days on which policy actions were announced: September 29, October 15, and November 17, 1998; and June 30, August 24, and November 16, 1999.

The broader range of collateral approved for repurchase transactions—mainly pass-through mortgage securities of government-sponsored enterprises and STRIP securities of the U.S. Treasury—would facilitate the Manager's task of addressing what could be very large needs to supply reserves in the succeeding months, primarily in response to rapid increases in the demand for currency, at a time of potentially heightened demand in various markets for U.S. government securities. The standby financing facility, authorizing the Federal Reserve Bank of New York to auction the above-mentioned options to the government securities dealers that are regular counterparties in the System's open market operations, would encourage marketmaking and the maintenance of liquid financing markets essential to effective open market operations. The standby facility was also viewed as a useful complement to the special liquidity facility, which was to provide sound depository institutions with unrestricted access to the discount window, at a penalty rate, between October 1999 and April 2000. Finally, the decision to extend the maximum maturity on repurchase and matched sale-purchase transactions was intended to bring the terms of such transactions into conformance with market practice and to enhance the Manager's ability over the following months to implement the unusually large reserve operations expected to be required around the turn of the year.

Incoming information during the period leading up to the FOMC's October meeting suggested that the growth of domestic economic activity had picked up from the second quarter's pace, and foreign economies appeared to be strengthening more than had been anticipated, potentially adding pressure to already-taut labor markets and possi-

bly creating inflationary imbalances that would undermine economic performance. But the FOMC viewed the risk of a significant increase in inflation in the near term as small and decided to await more evidence on how the economy was responding to its previous tightenings before changing its policy stance. However, the Committee anticipated that the evidence might well signal the need for additional tightening, and it again announced a directive that was biased toward restraint.

Information available through mid-November pointed toward robust growth in overall economic activity and a further depletion of the pool of unemployed workers willing to take a job. Although higher real interest rates appeared to have induced some softening in interest-sensitive sectors of the economy, the anticipated moderation in the growth of aggregate demand did not appear sufficient to avoid added pressures on resources, predominantly labor. These conditions, along with further increases in oil and other commodity prices, suggested a significant risk that inflation would pick up over time, given prevailing financial conditions. Against this backdrop, the FOMC raised the target for the federal funds rate an additional $\frac{1}{4}$ percentage point in November. At that time, a symmetric directive was adopted, consistent with the Committee's expectation that no further policy move was likely to be considered before the February meeting. In a related action, the Board of Governors approved an increase in the discount rate of $\frac{1}{4}$ percentage point, to 5 percent.

At the December meeting, FOMC members held the stance of policy

unchanged and, to avoid any misinterpretation of policy intentions that might unsettle financial markets around the century date change, announced a symmetric directive. But the statement issued after the meeting highlighted members' continuing concern about inflation risks going forward and indicated the Committee's intention to evaluate, as soon as its next meeting, whether those risks suggested that further tightening was appropriate.

The FOMC also decided on some modifications to its disclosure procedures at the December meeting, at which the working group established at the August meeting transmitted its final report and proposals. These modifications, announced in January 2000, consisted primarily of a plan to issue a statement after every FOMC meeting that not only would convey the current stance of policy but also would categorize risks to the outlook as either weighted mainly toward conditions that may generate heightened inflation pressures, weighted mainly toward conditions that may generate economic weakness, or balanced with respect to the goals of maximum employment and stable prices over the foreseeable future. The changes eliminated uncertainty about the circumstances under which an announcement would be made; they clarified that the Committee's statement about future prospects extended beyond the intermeeting period; and they characterized the Committee's views about future developments in a way that reflected policy discussions and that members hoped would be more helpful to the public and to financial markets. ■